

1998

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Recommended Citation

Miest, Ryan G., "Would the Real Scierter Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud" (1998). *Minnesota Law Review*. 2291.
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Note

Would the Real Scientist Please Stand Up: The Effect of the Private Securities Litigation Reform Act of 1995 on Pleading Securities Fraud

Ryan G. Miest*

Few issues divide the legal and business communities as vehemently as class action securities fraud suits. Corporate interest groups—primarily high technology companies, accounting firms, and securities underwriters¹—characterize such lawsuits as an unwarranted “litigation tax.”² These groups contend that most securities fraud claims are brought to extort settlements which primarily benefit attorneys.³ By contrast, consumer interest groups, including plaintiff’s lawyers, senior citizen organizations, and small investor groups,⁴ argue that private securities fraud litigation is necessary to protect investors from unscrupulous corporate actions.⁵ The political showdown between these

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1. See Timothy R. Donovan, *New Private Securities Lawsuit Reforms*, CORP. BOARD, Mar., 1996, at 10.

2. See Bruce Rubenstein, *Cease and Desist*, CORP. LEGAL TIMES, Sept. 1994, at 40.

3. One commentator succinctly summarized the business community’s view of private securities fraud litigation:

There is probably no other area of the law so rife with attorney abuse as federal securities law.

....

[Strike suits] represent everything Americans hate about our legal system; professional plaintiffs, fishing expeditions with boilerplate accusations of fraud, contingency-fee lawyers who make a huge profit even when the case does not reach trial, and multimillion-dollar settlements that reward the lawyers and resemble legal blackmail.

Louis M. Thompson Jr., *Legal Reform Overdue for Securities Litigation System*, HOUSTON BUS. J., May 26, 1995, available in 1995 WL 5873787.

4. See Donovan, *supra* note 1, at 10.

5. See Amy Neeno, *House Passes Securities Litigation Reform; Bill Heads to White House*, WEST’S LEGAL NEWS, Dec. 13, 1995, available in 1995

groups is a high-stakes battle: between 1988 and 1993, publicly traded companies paid \$2.5 billion to settle securities fraud claims.⁶

Securities fraud litigation helps to ensure the accuracy of investment information, which in turn results in properly valued securities and maximizes the efficiency of capital markets.⁷ However, private securities fraud litigation is also particularly vulnerable to abuse because the massive legal costs a defendant corporation incurs in defending a securities fraud suit typically outweigh the value of the settlement which can be negotiated.⁸ Therefore, a plaintiff who can keep his or her claim alive until discovery is virtually assured a settlement.⁹ motions on the

WL 907529. Because the Securities Exchange Commission lacks the resources to prosecute all violations of securities fraud laws, such claims also serve the public by providing additional deterrence to corporations. See *Concerning the Impact of the Private Securities Litigation Reform Act of 1995: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (statement of Arthur Levitt, Chairman, SEC), available in 1997 WL 11235194. Proponents of private securities fraud litigation argue that this function is increasingly indispensable in an era where the average American is more likely to have invested in the stock market, either through mutual funds or 401(k) plans. See *Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (statement of Leonard B. Simon, attorney), available in 1997 WL 11235199.

6. See Donovan, *supra* note 1, at 6. The dominant plaintiff's firm Milberg Weiss Bershad Hynes & Lerach, LLP has won more than \$1 billion dollars in settlements. See Pamela Sherrid, *The General Custer of Shareholder Lawsuits? How One Lawyer Helps Thwart Legal Reform*, U.S. NEWS & WORLD REP., Apr. 21, 1997, at 66-67.

7. See generally Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1 (1982) (providing a framework for analyzing whether investors suffered any injury as a result of an alleged misrepresentation or nondisclosure).

8. See *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 263 (2d Cir. 1993) ("[T]here is the interest in deterring the use of the litigation process as a device for extracting undeserved settlements as the price of avoiding the extensive discovery costs that frequently ensue once a complaint survives dismissal, even though no recovery would occur if the suit were litigated to completion."). Discovery costs account for approximately 80% of the costs of litigation in securities fraud cases. See Donovan, *supra* note 1, at 7. Some commentators argue that the settlements in Rule 10b-5 cases bear "little or no relationship to the merits of the plaintiffs' claims." See Barbara Moses, *Securities Litigation Reformed?*, 29 REV. SEC. & COMMODITIES REG. 37, 37 (1996). But see Joel Seligman, *The Merits Do Matter: A Comment on Professor Grundfest's "Disimplying Private Rights of Actions Under the Federal Securities Laws: The Commission's Authority"*, 108 HARV. L. REV. 438, 448-49 (1994) (claiming the existence of a relationship between the merits of a private litigation code under federal securities law and its settlement value).

9. By one estimate, less than one percent of cases go to trial. See Jordan

pleadings are thus the most significant contest in any securities fraud claim.¹⁰

To state a claim for relief for securities fraud, a plaintiff must allege that the defendant acted with scienter, which is typically the most difficult element of a securities fraud claim to plead.¹¹ Scienter is defined as knowledge on the part of one making a representation, at the time the statement was made, that it was false.¹² Thus, a plaintiff must allege that the false statements that are the basis of his claim were known by the defendant to be false when made, which usually requires some type of circumstantial evidence since direct evidence of a defendant's state of mind is almost nonexistent prior to discovery.¹³ The ability to effectively plead scienter often means the difference between dismissal and a large settlement.¹⁴ Therefore, pleading requirements for scienter are a critical component in striking a balance that eliminates non-meritorious claims while affording access to the judicial process for those truly injured by securities fraud.¹⁵

In response to the debate over the impact of securities fraud litigation, Congress enacted the Private Securities Litigation Re-

Eth & Michael Dicke, *Insider Stock Sales in Rule 10b-5 Corporate Disclosure Cases: Separating the Innocent from the Suspicious*, 1 STAN. J.L. BUS. & FIN. 97, 111 (1994). Other estimates have placed the number at seven percent. See S. REP. NO. 104-98, at 9 (1995), reprinted in 1995 U.S.C.A.N. 679, 688.

10. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 740 (1975) ("[E]ven a complaint which by objective standards may have very little chance of success at trial has a settlement value to plaintiff . . . so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.") (emphasis added); see also Barbara Moses & Rachael K. Jeck, *Securities Litigation Reform*, 28 REV. SEC. & COMMODITIES REG. 31, 32 (1995) (identifying one-way discovery, potentially enormous verdicts, and the disruption of normal business activities as factors dictating settlement after a claim survives initial pleading motions).

11. See Michael A. Collora, *New Terrain, Strategies for Mass. Plaintiffs*, MASS. LAW. WKLY., Jan. 8, 1996, at 11.

12. See BARRON'S LAW DICTIONARY 432 (3d ed. 1991). In the securities fraud context, certain forms of recklessness also constitute scienter. See discussion *infra* Part I.B.1.

13. See, e.g., D. Brian Hufford, *Deterring Fraud vs. Avoiding the "Strike Suit": Reaching an Appropriate Balance*, 61 BROOK. L. REV. 593, 624-25 (1995) (discussing the difficulties of defining a motive at the pleading stage).

14. See Sherrid, *supra* note 6, at 67 (quoting William S. Lerach, securities fraud lawyer, as saying "Trials turn on such distinctions."); see also *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 264 (2d Cir. 1993) (discussing the ramifications of pre-trial motions in securities fraud actions).

15. See William H. Kuehnle, *On Scienter, Knowledge, and Recklessness Under the Federal Securities Laws*, 34 HOUS. L. REV. 121, 175-76 (1997) (noting that the scienter requirement defines the scope of liability under federal securities laws).

form Act of 1995¹⁶ (PSLRA), which implemented various procedural protections in an effort to curb frivolous litigation. One such procedural protection was section 21D(b)(2),¹⁷ which was enacted to strengthen pleading requirements for scienter by introducing a heightened and nationally uniform pleading standard.¹⁸ Although Congress intended section 21D(b)(2) to resolve a circuit split over the pleading requirements for scienter, imprecise drafting and conflicting legislative history have resulted in continuing disagreement among federal courts over the proper interpretation of the provision.¹⁹

Federal courts interpreting section 21D(b)(2) must confront two interrelated issues. First, a court must consider what impact, if any, the provision has on the substantive law of securities fraud. This inquiry typically focuses on whether recklessness, in addition to intent, constitutes scienter under 21D(b)(2). This issue is not a pleading issue; rather, it involves the substantive definition of scienter.²⁰ However, "to the extent . . . that recklessness constitutes scienter, it has to be in the pleading standard in some fashion since if it cannot be pled, then it is no longer a basis for establishing scienter."²¹ Therefore, defining

16. Pub. L. No. 104-67, 109 Stat. 737, amends the Securities Act of 1933 (codified as amended at 15 U.S.C. §§ 77a-77bfff (1994 & Supp. I 1995)), and the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. §§ 78a-78lll (1994 & Supp. I 1995)).

17. The section provides:

In any private action arising under this chapter in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (Supp. I 1995) (emphasis added).

18. See Edward Brodsky, *Scienter Under the Reform Act of 1995*, N.Y. L.J., Jan. 8, 1997, at 3 (discussing Congress's intent to strengthen pleading standards); Paul H. Dawes, *Pleading Motions Under the Private Securities Litigation Reform Act of 1995*, in SECURITIES LITIGATION 1996, at 37, 60 (PLI Corp. Law & Practice Course Handbook Series No. 958, 1996) (noting that uniformity is a primary purpose of 21D(b)(2)).

19. See Seth Goodchild & Stephenie L. Brown, *Institutional Investors and PSLRA Pleading Standard*, N.Y. L.J., Sept. 5, 1997, at 1 ("The most controversial and hotly litigated issue in securities fraud class actions in the post-Private Securities Litigation Reform Act (PSLRA) era is the Act's heightened requirements for pleading scienter."); see also discussion *infra* Part II (considering competing judicial interpretations of 21D(b)(2)).

20. See *In re Baesa Sec. Litig.*, 96 F. Supp. 238, 242 (S.D.N.Y. 1997).

21. HAROLD S. BLOOMENTHAL ET AL., SECURITIES LAW HANDBOOK § 17.03[1][b], at 946 (1997 ed.).

the boundary of scienter is a necessary prerequisite to evaluating pleadings under 21D(b)(2). Second, a court must determine what facts a plaintiff must plead to satisfy the 21D(b)(2) standard. While 21D(b)(2) clearly requires a factual basis for pleading scienter, the provision does not specify what facts are necessary to survive a motion to dismiss.²² Specifically, 21D(b)(2) calls into question the viability of a Second Circuit pre-PSLRA pleading test which allows plaintiffs to plead scienter by alleging a motive and opportunity to commit fraud.²³

This Note argues that section 21D(b)(2) requires plaintiffs to plead direct or circumstantial evidence giving rise to a strong inference of reckless or knowing misrepresentation in order to plead scienter under section 21D(b)(2). Part I recounts the development of private securities fraud litigation and the legislative history of section 21D(b)(2). Part II outlines the split in the federal courts over the proper interpretation of 21D(b)(2). Part III critically examines the text and legislative history of section 21D(b)(2) and concludes that the provision did not alter pre-PSLRA liability for recklessness but did eliminate the motive and opportunity test as an independent pleading method. Part IV argues that this interpretation is preferable as a matter of policy as well.

I. PRIVATE SECURITIES LITIGATION: THE JUDICIAL EXPANSION AND LEGISLATIVE CONTRACTION OF AN IMPLIED CAUSE OF ACTION

A. THE PRIVATE CAUSE OF ACTION UNDER RULE 10B-5

The modern era of regulated securities markets began with the enactment of the Securities Act of 1933²⁴ and the Securities Exchange Act of 1934,²⁵ which were efforts to insure uniform access to information and to increase investors's ability to rely on corporate releases.²⁶ In 1942, under authority of the Securities

22. The provision requires a plaintiff to "state with particularity facts giving rise to a strong inference" that the defendant acted with scienter, but does not specify what facts give rise to such a strong inference. 15 U.S.C. § 78u-4(b)(2) (Supp. I 1995).

23. See, e.g., *In re Baesa*, 969 F. Supp. at 242 (concluding that motive and opportunity pleading does not automatically suffice to raise a strong inference of scienter).

24. 15 U.S.C. §§ 77a-77bbbb (1994 & Supp. I 1995).

25. 15 U.S.C. §§ 78a-78lll (1994 & Supp. I 1995).

26. See *Randall v. Loftsgaarden*, 478 U.S. 647, 664 (1986).

Exchange Act section 10(b),²⁷ the Securities Exchange Commission (SEC) instituted Rule 10b-5, which prohibited securities fraud.²⁸ Although neither section 10(b) of the Securities Exchange Act nor Rule 10b-5 explicitly provided a private cause of action,²⁹ federal courts soon recognized the rights of private litigants to seek relief under Rule 10b-5.³⁰ To state a claim for relief under Rule 10b-5, courts require plaintiffs to allege reliance on material misstatements or omissions which were made with scienter in connection with the purchase or sale of a security.³¹ The 10b-5 claim has become the most popular cause of action for se-

27. Section 10(b) of the Securities Exchange Act states:

It shall be unlawful for any person . . .

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1994). Courts and commentators have identified numerous policies underlying section 10(b), all of which are closely related. See 5A ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 6.01, at 191 (1997). Such policies include preservation of free and honest markets, equal access to information, equalization of bargaining position, disclosure, protection of investors, fairness, fostering investor trust, and both deterrence and compensation. See *id.*

28. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975). Rule 10b-5 provides:

It shall be unlawful for any person . . .

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1997).

29. See *Blue Chip Stamps*, 421 U.S. at 729.

30. See, e.g., *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (finding a private cause of action under 10b-5). The Supreme Court did not directly address the private cause of action under Rule 10b-5 until *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971), by which time the viability of the 10b-5 private cause of action was well established. See JACOBS, *supra* note 27, § 8.02, at 236.

31. See, e.g., *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986). It should be noted that, because these elements are judge-made law, they may vary considerably between jurisdictions. See generally JACOBS, *supra* note 27, §§ 5, 6.01, at 177-94. (outlining how administrative and legislative history and the policy underlying Rule 10b-5 influence its application).

curities fraud plaintiffs,³² primarily because most courts allow class certification for such claims while also allowing rather conclusory pleadings.³³

B. PLEADING SCIENTER UNDER RULE 10B-5 AND RULE 9(B)

Before the PSLRA, the scienter requirement of Rule 10b-5 presented federal courts with two issues: first, whether recklessness constituted scienter as a substantive basis of liability; and second, whether, as a matter of procedure, plaintiffs were required to plead specific facts showing scienter.

1. Pre-PSLRA Courts Uniformly Held That Intent and Recklessness Constitute Scienter Under Rule 10b-5

As a matter of substantive law, Rule 10b-5 provides no guidance as to what state of mind a defendant must possess to be found liable; thus, courts were required to determine whether negligence, recklessness, or intent were sufficient. The Supreme Court addressed the issue of substantive liability in *Ernst & Ernst v. Hochfelder*, holding that a negligent state of mind does not constitute scienter as required by Rule 10b-5.³⁴ Although the Court reasoned that scienter embraced an intent to deceive, it did not address the sufficiency of recklessness in satisfying the Rule.³⁵

While the Supreme Court failed to determine whether recklessness constituted scienter, every circuit court of appeals to consider the issue has found recklessness to be an actionable state of mind under Rule 10b-5.³⁶ Although recklessness is sub-

32. See Collora, *supra* note 11, at 11; Moses & Jeck, *supra* note 10, at 32. The popularity and growth of the Rule 10b-5 private action led Justice Rehnquist to describe it as "a judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps*, 421 U.S. at 737.

33. See Moses & Jeck, *supra* note 10, at 32 (discussing reasons for the claim's popularity).

34. 425 U.S. 185, 193-94 (1976).

35. See *id.* at 194 n.12. The court stated "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id.*

36. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991); *In re Phillips Petroleum Sec. Litig.*, 881 F.2d 1236, 1244 (3d Cir. 1989); *Van Dyke v. Coburn Enter. Inc.* 873 F.2d 1094, 1100 (8th Cir. 1989); *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814 (11th Cir. 1989); *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982); *Broad v. Rockwell Int'l Corp.*, 642 F.2d 929, 961-62 (5th Cir. 1981) (*en banc*) *cert. denied*, 454 U.S. 965 (1981); *Mansbach v. Prescott, Ball & Tur-*

ject to varying interpretations,³⁷ most courts have reasoned that the recklessness required by Rule 10b-5 is that the defendant acted without regard to the truth of the statement—essentially, bad faith.³⁸ Thus, federal courts typically find that a plaintiff establishes recklessness when she shows that the defendant was aware of a substantial possibility that his statement was inaccurate or was aware that the statement was made without a solid basis for determining its truthfulness.³⁹

2. Pre-PSLRA Courts Split on the Issue of Pleading Specificity

While courts uniformly held that recklessness constituted scienter under Rule 10b-5, they were divided on the issue of what facts alleging scienter, if any, plaintiffs had to plead to survive a motion to dismiss or summary judgment motion. Faced with a lack of guidance from the statute, regulation, or the Supreme Court, federal circuit courts turned to Rule 9(b) of the Federal Rules of Civil Procedure, which provides that "[i]n all averments of fraud . . . the circumstances constituting fraud . . . shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally."⁴⁰ Examining this language, the Second and Ninth Circuit developed two distinct standards for pleading sci-

ben, 598 F.2d 1017, 1023-24 (6th Cir. 1979); *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978); *Rolf v. Byth Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978); *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977), *cert. denied*, 434 U.S. 875 (1977).

37. See, e.g., *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 241 (S.D.N.Y. 1997) (noting that recklessness denotes a type of negligence in some contexts). See generally Kuehnle, *supra* note 15, at 178-87 (discussing various subjective and objective definitions of recklessness under the common law of fraud and federal securities laws).

38. The standard enunciated by the Seventh Circuit in *Sundstrand Corp. v. Sun Chem. Corp.* is the definition typically employed in the securities fraud context. See 553 F.2d at 1045. The court defined reckless conduct as:

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Id. (citing *Franke v. Midwestern Okla. Dev. Auth.*, 428 F. Supp. 719, 725 (W.D. Okla. 1976)).

39. See Kuehnle, *supra* note 15, at 168 (explaining the federal recklessness standard). Both standards imply a moral deficiency rather than mere carelessness. See *id.* at 170.

40. FED. R. CIV. P. 9(b).

enter: one requiring only a general allegation of scienter and one requiring a degree of particularity.⁴¹

In *In re Glenfed, Inc. Securities Litigation*, the Ninth Circuit held that scienter, as a "condition of mind" under Rule 9(b), could be pleaded in a general or conclusory manner.⁴² The court reasoned that this was the only interpretation textually compatible with Rule 9(b),⁴³ and that the judiciary was not empowered to change pleading standards on the basis of policy.⁴⁴ Therefore, in the Ninth Circuit, a plaintiff could satisfy the scienter requirement by pleading that the necessary scienter existed, without setting forth any facts supporting that allegation.⁴⁵

Although the Second Circuit agreed that state of mind could be averred generally, it also held that general pleading did not mean conclusory pleading.⁴⁶ Thus, Second Circuit courts required plaintiffs to allege specific facts which created a "strong inference" that the defendants possessed the requisite scienter.⁴⁷ A plaintiff could satisfy this strong inference pleading standard by presenting direct evidence of scienter or by meeting one of two pleading tests.⁴⁸ First, a plaintiff could establish a strong inference of scienter by pleading facts which constituted "circumstantial evidence" of either reckless or intentional behavior.⁴⁹ Alterna-

41. See generally Laurence A. Steckman & Kenneth M. Moltner, *Pleading Scienter in Securities Fraud Cases Under Rule 9(b)—Is the Pleading of Facts Sufficient to Give Rise to a "Strong Inference" of Fraudulent Intent Really Incompatible with the Federal Rules?*, 1995 ANN. SURV. AM. L. 99 (1995) (discussing the split of authority between the Second Circuit and the Ninth Circuit regarding pleading standards for scienter).

42. See 42 F.3d 1541, 1545 (9th Cir. 1994) (en banc).

43. See *id.*

44. See *id.* at 1545-46. The court noted the "weeding out" effect of the Second Circuit test, but felt that adding new pleading requirements was "a job for Congress." *Id.* at 1546.

45. See *id.* at 1545.

46. See *Connecticut Nat'l Bank v. Fluor Corp.*, 808 F.2d 957, 962 (2d Cir. 1987) (explaining that plaintiffs must plead some factual basis for allegations of intent); *Ross v. A.H. Robins Co.*, 607 F.2d 545, 558 (2d Cir. 1979) (explaining that plaintiffs must plead some factual basis for allegations of intent), *cert. denied*, 446 U.S. 946 (1980); see also Steckman & Moltner, *supra* note 41, at 99 (outlining the Second Circuit standard).

47. See *Connecticut Nat'l Bank*, 808 F.2d at 962; *Ross*, 607 F.2d at 558.

48. See *Shields v. Citytrust Bankcorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (discussing alternative methods by which a plaintiff may properly plead scienter); *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993) (discussing alternative methods by which a plaintiff may properly plead scienter), *cert. denied* 511 U.S. 1017 (1994).

49. See *In re Time Warner*, 9 F.3d at 269.

tively, a plaintiff could plead "motive and opportunity" to create a strong inference of scienter, by showing that the defendants had a financial motive to commit fraud and a clear opportunity to do so.⁵⁰

C. ENACTMENT OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 AND 21D(B)(2)

The split between the Second and Ninth Circuits became one of several major issues addressed in the Private Securities Litigation Reform Act of 1995.⁵¹ One of the most controversial sections of the Act was section 21D(b)(2), which ostensibly resolved this circuit split by requiring plaintiffs to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."⁵² Although legislators agreed on the inclusion of the strong inference standard, the provision as enacted did not resolve the definition of scienter or the acceptable methods of pleading it.

1. House Deliberations

The first bill proposed in the House of Representatives, Title II of H.R. 10, signaled a radical departure from Rule 10b-5 law as defined by federal circuit courts. One provision of the bill specifically addressed the issue of scienter, requiring plaintiffs to plead direct evidence of scienter and abolishing liability for recklessness.⁵³ This section mandated a level of scienter plead-

50. See *id.* at 269-71.

51. Pub. L. No. 104-67, 109 Stat. 737 (1995). In a piecemeal fashion, the Act addressed a number of securities fraud issues, including limitations on liability and damages, checks on professional plaintiffs, and heightened pleading burdens. See generally Stephen F. Black et al., *The Private Securities Litigation Reform Act of 1995: A Preliminary Analysis*, in 15TH ANNUAL FEDERAL SECURITIES INSTITUTE 621 (1997) (providing a broad overview of the various provisions of the PSLRA).

52. 15 U.S.C. § 78u-4(b)(2) (Supp. 1997).

53. See H.R. 10, 104th Cong. § 204 (1995). The provision stated:

SEC. 10A. REQUIREMENTS FOR SECURITIES FRAUD ACTIONS

(a) SCIENTER.—In any action under section 10(b), a defendant may be held liable for money damages only on proof—

(1) that the defendant made an untrue statement of a material fact, or omitted to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; and

(2) that the defendant knew the statement was misleading at the time it was made, or intentionally omitted to state a fact knowing that such omission would render misleading the statements made at the time they were made.

(b) REQUIREMENT FOR EXPLICIT PLEADING AND PROOF OF

ing exceeding even the stringent Second Circuit standard.⁵⁴ The proposal was met with considerable opposition by the Securities Exchange Commission, which objected to the elimination of recklessness as a condition for liability.⁵⁵ The Commission's stance was apparently influential, because the final House version of the bill, titled H.R. 1058, resolved the question of substantive liability by reinstating liability for recklessness.⁵⁶ Although the bill passed the House,⁵⁷ it was eventually rejected by the Conference Committee in favor of the Senate version.⁵⁸

2. Senate Deliberations and the Enactment of Section 21D(b)(2)

Senate proposal S. 240 marked the first appearance of the Second Circuit's strong inference language in the proposed legislation. Although the strong inference standard was added to the bill, language pertaining to the Second Circuit's motive and opportunity and circumstantial evidence pleading tests was not in-

SCIENTER.—In any action under section 10(b) in which it is alleged that the defendant—

- (1) made an untrue statement of a material fact; or
- (2) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall allege specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred. . . .

Id. (emphasis added).

54. See *The Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecom. and Fin. of the House Comm. on Commerce*, 104th Cong. 199 (1995) [hereinafter *H.R. 10 Hearings*] (statement of Arthur Levitt, Chairman, SEC).

55. See H.R. REP. NO. 104-50 at 63 (1995). Chairman Levitt stated the SEC's stance:

We really want corporations—we want executives of corporations—to worry about the accuracy of their disclosures. It is the best way I know to assure the markets of a continuous stream of reliable, accurate information. Any higher scienter standard threatens the process that has made our markets what they are. Indeed, an actual knowledge standard could create a legal incentive to ignore indication of fraud. The phrase, "Ignorance is bliss," could take on, unhappily, new meaning.

H.R. 10 Hearings, *supra* note 54, at 194-95 (statement of Arthur Levitt, Chairman, SEC).

56. See 141 CONG. REC. H2306 (daily ed. Feb. 27, 1995); H.R. 1058, 104th Cong. (1995). H.R. 1058 adopted the *Sundstrand* definition of recklessness. See *supra* text accompanying notes 36-39 (discussing the securities fraud definition of recklessness).

57. The bill passed on a vote of 325 to 99. See 141 CONG. REC. H2863-64 (daily ed. March 8, 1995).

58. See *infra* Part I.C.2. (discussing the evolution of the Senate bill).

cluded.⁵⁹ S. 240 was met with approval from both the SEC and the White House.⁶⁰

In June of 1995, Senator Arlen Specter proposed an amendment that further clarified the scienter pleading issue by adopting the Second Circuit's case law in full.⁶¹ Under the Specter Amendment, a plaintiff could meet 21D(b)(2)'s "strong inference" standard by pleading facts which would meet either the "circumstantial evidence" test or the "motive and opportunity" test employed in the Second Circuit.⁶² Although the amendment passed,⁶³ the language was later dropped during conference report mark-ups.⁶⁴

The final Conference Report and accompanying Statement of the Managers were released on November 28, 1995.⁶⁵ House proposal H.R. 1058 had been dropped in favor in S. 240, and the Conference Committee included the "strong inference" standard in the text of the scienter pleading provision.⁶⁶ The Conference Committee expressed two reservations, however, in its Statement of the Managers. First, the Committee stated that "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the

59. See S. REP. NO. 104-98, at 15 (1995). The Senate Banking Committee, which was responsible for the addition, stated that it did "not intend to codify the Second Circuit's caselaw interpreting this pleading standard, although courts may find this body of law instructive." *Id.*

60. See William S. Lerach & Eric Alan Isaacson, *Pleading Scienter Under Section 21D(b)(2) of the Securities Exchange Act of 1934: Motive, Opportunity, Recklessness, and the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 893, 944 (1996).

61. The proposed addition read as follows:

[A] strong inference that the defendant acted with the required state of mind may be established either—

(A) by alleging facts to show that the defendant had both motive and opportunity to commit fraud; or

(B) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness by the defendant.

141 CONG. REC. S9170 (daily ed. June 27, 1995). The proposal's text was based on the Second Circuit Court of Appeal's language in *Beck v. Manufacturers Hanover Trust Co.*, 820 F.2d 46, 50 (2d Cir. 1987).

62. See, e.g., *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-269 (2d Cir. 1993).

63. The amendment passed by a vote of 57 to 42. See 141 CONG. REC. S9201 (daily ed. June 28, 1995). It was also included in S. 240 as passed by the Senate. See 141 CONG. REC. S9219, S9222 (daily ed. June 28, 1995).

64. See H.R. REP. NO. 104-369, at 41 n.23 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 740 n.23.

65. See H.R. REP. NO. 104-369 (1995), reprinted in 1995 U.S.C.C.A.N. 679.

66. See *id.* at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 679, 740.

Second Circuit's case law interpreting this pleading standard.⁶⁷ Second, in an apparent reference to the omission of Senator Specter's amendment, the Committee stated that "the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness."⁶⁸ The Committee did not explain this omission, however, leaving courts to consider whether the statement constitutes a disavowment of these legal doctrines, or merely an unwillingness to codify the aforementioned language.

President Clinton vetoed the legislation on December 19, 1995.⁶⁹ The President objected not to the statute's text, but to the Statement of the Managers accompanying the Conference Committee Report, which he felt would raise the pleading standards beyond that required in the Second Circuit.⁷⁰ Congress overrode the President's veto and the bill passed into law on December 22, 1995.⁷¹

II. FEDERAL COURT INTERPRETATIONS OF SECTION 21D(B)(2)

As it turned out, Senator Specter's concerns regarding judicial implementation of 21D(b)(2) were well-founded. While it is clear that the Ninth Circuit's general pleading standard is no longer sufficient under section 21D(b)(2),⁷² the provision's impact on both

67. *Id.*

68. *Id.* at 41 n.23.

69. President's Message to the House of Representatives Returning Without Approval the Private Securities Litigation Reform Act of 1995, 31 WEEKLY COMP. PRES. DOC. 2210 (Dec. 19, 1995).

70. More specifically, the President explained:

I believe that the pleading requirements of the Conference Report with regard to a defendant's state of mind impose an unacceptable procedural hurdle to meritorious claims being heard in Federal courts. I am prepared to support the high pleading standard of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court. But the conferees make crystal clear in the Statement of Managers their intent to raise the standard even beyond that level. I am not prepared to accept that.

Id.

71. The House vote was 319 to 100; the Senate voted 68-30. See John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335, 353 (1996).

72. See *Powers v. Eichen*, 977 F. Supp. 1031, 1038 (S.D. Cal. 1997); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1310-11 (C.D. Cal. 1996). For a discussion of the Ninth Circuit's general pleading requirements, see *supra* text accompanying notes 42-45. Because 21D(b)(2) requires plaintiffs to "state with particularity facts giving rise to a strong in-

the substantive liability threshold and the procedural methods of meeting it are uncertain. Faced with inconsistent legislative history and ambiguous statutory text, federal courts are divided over the proper interpretation of the provision.⁷³ Federal courts interpreting 21D(b)(2) generally fall into one of three categories.⁷⁴

A. SECTION 21D(B)(2) REQUIRES HIGHER PLEADING AND LIABILITY STANDARDS THAN THOSE OF THE SECOND CIRCUIT

Several courts have held that section 21D(b)(2) eliminates both the motive and opportunity test as an independent method of adequately pleading scienter and the sufficiency of recklessness as a basis of substantive liability.⁷⁵ The reasoning of the Northern District Court of California in *In re Silicon Graphics, Inc. Securities Litigation* exemplifies this interpretation.⁷⁶ Discussing the motive and opportunity test, the *Silicon Graphics* court noted the Conference Committee's intent to strengthen pleading standards and the Committee's express refusal to codify Second Circuit pleading tests.⁷⁷ The court also noted the Conference Committee's rejection of the Specter amendment and President

ference," 15 U.S.C. § 78u-4(b)(2) (1994), it supersedes the Ninth Circuit general pleading standard.

73. Compare *Marksman Partners*, 927 F. Supp. at 1310-13 (holding that 21D(b)(2) retains both the motive and opportunity test and recklessness liability), *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997) (same), *Shahzad v. H.J. Meyers & Co.*, No. 95 Civ. 6196 (DAB), 1997 WL 47817, at *7-8 (S.D.N.Y. Feb. 6, 1997) (holding that 21D(b)(2) is a de facto codification of Second Circuit pleading standards), and *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1250-57 (N.D. Ill. 1997) (same), with *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 373-74 (E.D. Pa. 1997) (holding that 21D(b)(2) eliminates the motive and opportunity test and recklessness liability and adopts a conscious behavior test), *Norwood Venture Corp. v. Converse Inc.*, 959 F. Supp. 205, 208-09 (S.D.N.Y. 1997) (same), *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5-6 (N.D. Cal. Sept. 25, 1996) (reaffirmed on motion to reconsider at 970 F. Supp. 746, 757 (N.D. Cal. May 23, 1997)) (same), and *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42, 46-50 (D. Mass. 1997) (same). The *In re Baesa* decision represents a third distinct approach. See 969 F. Supp. 238, 239 (S.D.N.Y. 1997) (holding that 21D(b)(2) abolishes the motive and opportunity test but does not change liability for recklessness); *accord Press v. Quick & Reilly*, No. 96 Civ. 4278 (RPP), 1997 WL 458666, at *2 (S.D.N.Y. Aug. 11, 1997).

74. See Dennis J. Block & Jonathan M. Hoff, *Scienter Requirement Under the Securities Litigation Reform*, N.Y. L.J., July 17, 1997, at 5.

75. See *In re Silicon Graphics*, 1996 WL 664639, at *6; *Norwood Venture Corp.*, 959 F. Supp. at 208; *Friedberg*, 959 F. Supp. at 49-50.

76. See 1996 WL 664639, at *6.

77. See *id.* at *5. The court found that "the legislative history, the most definitive part of which [was] the Conference Committee Report, establish[ed] the SRA standard as stricter than the Second Circuit standard." *Id.* at *6 n.4.

Clinton's belief that 21D(b)(2) adopted a new, more stringent standard.⁷⁸ Based on this legislative evidence, the court concluded that "Congress did not intend to codify the Second Circuit standard," but instead intended to codify a heightened pleading standard which disposed of the motive and opportunity test.⁷⁹ The court held that under section 21D(b)(2), a "plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants" and cannot survive a motion to dismiss by pleading motive and opportunity to commit fraud.⁸⁰

In addition to holding that 21D(b)(2) abolished the motive and opportunity test, the *Silicon Graphics* court held that recklessness was no longer a sufficient basis of liability for a 10b-5 claim.⁸¹ Since the court did not distinguish between the substantive concept of scienter and the procedural pleading tests, its analysis of recklessness under 21D(b)(2) paralleled its discussion of the motive and opportunity test.⁸² The court reasoned that Congress's intent to strengthen pleading standards, as well as the PSLRA's goal of reducing frivolous litigation, required it to eliminate liability for recklessness as well as eliminate the motive and opportunity test.⁸³

B. SECTION 21D(B)(2) AS A DE FACTO CODIFICATION OF SECOND CIRCUIT CASE LAW

In *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*, the Central District Court of California offered a second

78. *See id.* at *5.

79. *Id.* at *6.

80. *Id.*

81. *See id.* at *6-7. The court reconsidered its decision to eliminate recklessness as a basis for liability when it examined the plaintiff's amended complaint in *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746 (N.D. Cal. 1997). The court adhered to its original interpretation of the provision's legislative history, although it defended its elimination of recklessness by arguing that it was consistent with Second Circuit law. *See id.* at 755-757. The court appeared to waver slightly on its abolition of recklessness by reasoning that its interpretation of intent encompassed some forms of recklessness, although the contours of this definition were left undefined. *See id.* at 757.

82. *See In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5-6 (N.D. Cal. Sept. 25, 1996). The court found the Conference Committee Report virtually dispositive with regard to the issue of recklessness. *See id.* at *5.

83. *See id.* at *6. The court admonished the plaintiff for "resist[ing] the political reality underlying the SRA," and felt that its "interpretation [wa]s most consistent with Congress's policy concerns and legislative intent." *Id.* at *7.

interpretation of section 21D(b)(2).⁸⁴ The *Marksman Partners* interpretation, which has been adopted by a number of courts, retains both liability for recklessness and the Second Circuit's motive and opportunity pleading test.⁸⁵ Analyzing the provision's impact on substantive liability, the *Marksman Partners* court noted that the "safe harbor" and "joint and several liability" provisions of the PSLRA explicitly eliminate liability for reckless misstatements in certain circumstances, while section 21D(b)(2) does not.⁸⁶ The court concluded that this fact strongly implied that Congress did not intend to eliminate liability for recklessness in 10b-5 claims.⁸⁷ According to the court, the Conference Committee report, with its reference to Second Circuit law, reinforced this conclusion.⁸⁸

The court next discussed the sufficiency of motive and opportunity pleading under section 21D(b)(2).⁸⁹ The court noted that the Second Circuit's pleading standard was the most stringent in existence, and that Congress decided to include Second Circuit language in the provision.⁹⁰ These two facts implied that Congress intended to codify Second Circuit law, including the motive and opportunity test.⁹¹ Furthermore, the court argued that the motive and opportunity test still required plaintiffs to create a strong inference of fraudulent intent thereby complying with Congress's intent to strengthen pleading standards.⁹²

84. 927 F. Supp. 1297 (C.D. Cal. 1996).

85. See *id.* at 1308-1312; accord *In re Health Management, Inc. Sec. Litig.*, 970 F. Supp. 192, 201 (E.D.N.Y. 1997); *Shahzad v. H.J. Meyers & Co.*, No. 95 Civ. 6196 (DAB), 1997 WL 47817, at *7-8 (S.D.N.Y. Feb. 6, 1997); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1250-57 (N.D. Ill. 1997).

86. See 927 F. Supp. at 1308, 1309 n.9.

87. See *id.* at 1309.

88. See *id.* at 1309 n.9. According to the court, the Conference Committee report "suggests that Congress did not intend to change the state of mind requirements of existing law . . . [which] is confirmed by the absence of any express abrogation in the PSLRA of recklessness liability." *Id.*

89. See *id.* at 1310-12.

90. See *id.* at 1310. "[T]he conference committee emphasized that the Second Circuit's pleading standards were the most stringent of any circuit's, and thus it is reasonable to assume that Second Circuit jurisprudence comes closest to approximating the PSLRA's new requirements." *Id.* The court also noted that the strong inference language used by the PSLRA "mirrors language traditionally employed by the Second Circuit in its application of Rule 9(b) to scienter pleadings." *Id.*

91. See *id.* at 1310-12.

92. See *id.* at 1311. By requiring plaintiffs to allege circumstances giving rise to a strong inference of fraudulent intent, "the 'motive and opportunity' test appears to be consistent with Congress's intent that scienter be pled with

The *Marksman Partners* court also addressed the Conference Committee's decision not to codify Second Circuit law and to omit motive and opportunity language.⁹³ The court reasoned that the report's language did not constitute a disavowment of the motive and opportunity test because Congress would have explicitly abandoned the motive and opportunity test in the body of the statute if it intended to do so.⁹⁴ Furthermore, the court reasoned, the report of the Senate Banking Committee authorizes courts to apply Second Circuit law.⁹⁵ Therefore, under *Marksman Partners*, a plaintiff may plead circumstantial evidence of recklessness or knowledge of falsity, or in the alternative, plead motive and opportunity which creates a strong inference of recklessness or knowledge of falsity.

C. SECTION 21D(B)(2) SUPERSEDES SECOND CIRCUIT PLEADING TESTS BUT DOES NOT ALTER EXISTING SUBSTANTIVE LAW

In *In re Baesa Securities Litigation*,⁹⁶ the Southern District of New York offered a third interpretation which has been followed by one other court.⁹⁷ The *Baesa* court held that 21D(b)(2) did not alter the substantive definition of scienter, but that pleading only "motive and opportunity" does not automatically create a strong inference of scienter sufficient to survive a motion to dismiss.⁹⁸ Discussing the question of whether 21D(b)(2) abrogates liability for recklessness, the *Baesa* court noted that the mental state required for liability was conceptually distinct from the factual allegations a plaintiff must plead to show a basis for requisite state of mind.⁹⁹ The court reasoned that because

more than conclusory or generic allegations." *Id.* at 1310-11.

93. *See id.* at 1310-12.

94. *See id.* at 1311. The court reasoned:

[A]n oblique reference to 'motive, opportunity and recklessness' in a footnote to the Conference Committee report . . . implies that Congress chose not to codify motive and opportunity as pleading requirements but does not indicate that Congress chose to specifically disapprove the motive and opportunity test. The Court has little doubt that when Congress wishes to supplant a judicially-created rule it knows how to do so explicitly, and in the body of the statute.

Id.

95. *See id.*

96. 969 F. Supp. 238 (S.D.N.Y. 1997).

97. *See* Press v. Quick & Reilly, No. 96 Civ. 4278 (RPP), 1997 WL 458666 (S.D.N.Y. Aug. 11, 1997).

98. *See* 969 F. Supp. at 238.

99. *See id.* at 240-42.

21D(b)(2) addresses only pleading¹⁰⁰ it does not change the sufficiency of recklessness for establishing liability.¹⁰¹ The court supported this conclusion by noting the great weight of case law establishing liability for recklessness and the absence of statutory language indicating a contrary Congressional intent.¹⁰²

The court then discussed the sufficiency of pleading "motive and opportunity" under 21D(b)(2).¹⁰³ Once again relying on the statute's text, the court noted that 21D(b)(2) codified the "strong inference" standard while failing to mention any particular test, including "motive and opportunity," which would satisfy the "strong inference" standard.¹⁰⁴ The court reasoned that this indicated an intent to eliminate motive and opportunity as an independently sufficient pleading test.¹⁰⁵ Thus, the court concluded, a plaintiff pleading only motive and opportunity generally does not create a strong inference of scienter and therefore will not survive a motion to dismiss.¹⁰⁶

III. THE LEGISLATIVE HISTORY AND TEXT OF SECTION 21D(B)(2) REQUIRES COURTS TO ADOPT THE *BAESA* STANDARD

An examination of the text and legislative history of 21D(b)(2) establishes that the standard for pleading scienter enunciated in *In re Baesa*, which requires plaintiffs to plead either direct or circumstantial evidence giving rise to a strong inference of reckless or knowing misconduct,¹⁰⁷ is most consistent with Congress's intent and the statutory language. This interpretation recognizes that section 21D(b)(2) is essentially a provision governing pleading that does not alter the substantive law of 10b-5 claims. This interpretation also reflects Congress's de-

100. See *id.* at 240.

101. See *id.* at 241-42.

102. See *id.* at 241. The court noted in passing a few cases that made references to recklessness in the legislative history, but rejected their "selective reading of the convoluted legislative history for the clear and unambiguous language of the statute." *Id.* at 241 & n.1.

103. See *id.* at 242.

104. See *id.*

105. See *id.*

106. See *id.* The court did note, however, that well-pleaded nonconclusory factual allegations regarding motive and opportunity are still relevant as circumstantial evidence of scienter and could, in some cases, provide the necessary "strong inference" of scienter. See *id.*

107. See *id.* at 238.

cision not to codify the motive and opportunity test by eliminating the test's use as an alternative method of pleading scienter.

A. SECTION 21D(B)(2) DOES NOT ABROGATE LIABILITY FOR RECKLESS MISSTATEMENTS

1. Courts Fail to Distinguish Between Procedural Pleading Requirements and Substantive Standards for Liability

The *Silicon Graphics* court concluded that the legislative history and purpose of 21D(b)(2) dictated abolishing liability for reckless misstatements.¹⁰⁸ In doing so, the court failed to acknowledge the difference between procedural pleading tests and substantive standards for liability.¹⁰⁹ This misunderstanding is exemplified by the court's discussion of the substance of Senator Specter's rejected amendment and the legislative history of 21D(b)(2).¹¹⁰

The *Silicon Graphics* court erred by stating that under Senator Specter's amendment "a plaintiff [could] use allegations of recklessness or motive and opportunity to establish fraudulent intent,"¹¹¹ implying that recklessness was the equivalent of motive and opportunity. Under the *Silicon Graphics* conceptualization, pleading recklessness was an alternative procedural method of pleading scienter. Because it conflated the issues of pleading and liability, the court failed to conduct an independent analysis of recklessness under section 21D(b)(2).

The *Silicon Graphics* approach is flawed because recklessness is a substantive element of scienter, whereas motive and opportunity pleading is a method by which a plaintiff can create a strong inference of scienter.¹¹² For example, before the enactment

108. See *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5-6 (N.D. Cal. Sept. 25, 1996).

109. The *Silicon Graphics* court was not the only court to confuse the relationship between pleading standards and liability standards. For example, a federal district court in Massachusetts also considered recklessness as an additional pleading test. See *Friedberg v. Discreet Logic*, 959 F. Supp. 42, 49 (D. Mass. 1997). Another case, *Partners, L.P. v. Sensormatic Electronics Corp.*, No. 96-C4072, 1997 WL 570771, at *18 (N.D. Ill. Sept. 10, 1997), held that the plaintiff had alleged "sufficient facts to raise a 'strong inference' of the defendants 'motive and opportunity' to commit the fraud" and had therefore satisfied section 21D(b)(2).

110. See *Silicon Graphics*, 1996 WL 664639, at *5.

111. *Id.*

112. See *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268-69 (2d Cir. 1993). The *Time Warner* court sets out the motive and opportunity test and

of the PSLRA, a plaintiff in the Second Circuit could allege a motive and opportunity which would create a strong inference of reckless or knowing misconduct.¹¹³ By ostensibly eliminating recklessness as a method of pleading scienter, the *Silicon Graphics* court effectively removed recklessness as basis for liability.¹¹⁴ This is clearly improper because section 21D(b)(2) is a provision addressing only pleading standards and it does not purport to alter substantive liability standards.¹¹⁵

2. Courts That Eliminate Liability for Recklessness

Misconstrue Section 21D(b)(2)'s Text and Legislative History

a. *Silicon Graphics Court Misinterpreted Legislative History*

Despite the fact that section 21D(b)(2) was a provision primarily intended to address procedural pleading standards, the *Silicon Graphics* court claimed that 21D(b)(2)'s legislative history compelled its decision to eliminate liability for recklessness.¹¹⁶ In particular, the court found three pieces of history persuasive: 1) the rejected Specter Amendment, 2) the Statement of the Managers, and 3) the Presidential veto.¹¹⁷

The court first reasoned that the rejection of the Specter Amendment compelled a rejection of all the language contained

the circumstantial evidence test as two distinct methods of creating a strong inference of fraudulent intent. *See id.* "Fraudulent intent" encompasses both recklessness and knowledge.

113. *See id.*

114. *See Concerning the Impact of the Private Securities Litigation Reform Act of 1995: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 105th Cong. (1997) (statement of Arthur Levitt, Chairman, SEC), available in 1997 WL 11235194. Chairman Levitt expressed concern about decisions abolishing recklessness:

While these decisions address the pleading requirements of the Reform Act, they may also affect the substantive liability requirements of the securities laws themselves. The law is well established in each of the ten federal appellate courts that have considered the issue, that proof of recklessness satisfies the scienter requirement and can establish liability under the antifraud provisions of Section 10(b) of the Exchange Act.

Id. (emphasis added).

115. *See In re Baesa*, 969 F.3d at 240. As a preliminary matter, the court noted that "one must first distinguish between the mental state required for securities fraud liability ('scienter') and the level of pleadings required to adequately allege that mental state at the outset of a lawsuit. The [PSLRA] speaks only to the latter." *Id.*

116. *See In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *6 (N.D. Cal. Sept. 25, 1996).

117. *See id.*

therein.¹¹⁸ This blanket rejection approach is ill conceived, however, because it fails to account for the specific reasons why the amendment was not enacted. None of the opposition leveled at the Specter Amendment was directed at its reference to recklessness; rather, opponents criticized the Amendment's attempt to codify the Second Circuit's pleading tests.¹¹⁹ Moreover, if the Amendment was dropped out of desire to abolish liability for recklessness, the issue surely would have provoked opposition by the SEC, since a prior express attempt to abolish liability for recklessness faced overwhelming opposition.¹²⁰ Instead, the SEC response indicated that the draft was acceptable.¹²¹ The elimination of recklessness language was, therefore, a by-product of congressional resistance to presumptive pleading methods, not an attack on recklessness as a basis of liability.

The *Silicon Graphics* court next reasoned that the Conference Committee's decision "not to include in the pleading standard certain language relating to motive, opportunity, or recklessness"¹²² compelled elimination of both the motive and opportunity pleading test and recklessness liability.¹²³ Admittedly, the Conference Committee stated that it omitted "language pertaining to motive, opportunity and recklessness" because it intended to strengthen pleading standards,¹²⁴ but the *Silicon Graphics* court examined this statement out of context. Its interpretation of the Statement of the Managers fails on two grounds.

First, the Committee's statement addresses the removal of the Specter language from the provision, not the removal of recklessness from 21D(b)(2).¹²⁵ The opposition to the Specter Amendment was based on the Amendment's codification of Second Circuit case law, not on the inclusion of the universally recog-

118. See *id.* at *5.

119. See 141 CONG. REC. S9172 (daily ed. June 27, 1995) (statement of Sen. Bennett) (arguing that the courts should be given latitude as to how to meet the strong inference test); 141 CONG. REC. S9201 (daily ed. June 28, 1995) (statement of Sen. D'Amato) (arguing that explicit language would "straitjacket" the courts).

120. See *supra* note 55 for a description of the SEC's staunch opposition to a previous attempt in the House to abolish liability for recklessness.

121. See *Lerach & Isaacson, supra* note 60, at 948 & n.317.

122. H.R. CONF. REP. NO. 104-369, at 41 n.23 (1995).

123. See *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5 (N.D. Cal. Sept. 25, 1996).

124. See H.R. CONF. REP. NO. 104-369, at 41.

125. See *Lerach & Isaacson, supra* note 60, at 949.

nized assertion that a reckless state of mind constitutes scienter.¹²⁶ Thus, the Statement of the Managers simply restates what is already clear from the Specter Amendment debate: the motive and opportunity test was rejected by Congress,¹²⁷ but recklessness is still the appropriate standard of liability under 21D(b)(2).

Second, interpreting the Statement of Managers to eliminate liability for recklessness overlooks the fact that an explicit attempt to abolish liability for recklessness was soundly defeated in the House of Representatives.¹²⁸ An early House version of the bill which provided that a plaintiff must prove either knowledge or intent drew swift and vigorous response from the SEC, which claimed that eliminating the recklessness standard would discourage claimants and therefore reduce the deterrent effect of private securities litigation.¹²⁹ After the SEC protested the proposed change in liability standards, language creating liability for recklessness was restored to the bill and the issue was never again debated.¹³⁰ Given the heated debate over the House's attempt to jettison liability for recklessness, it seems unlikely that the Conference Committee would have quietly accomplished this feat in a footnote.

Finally, the *Silicon Graphics* court claimed that President Clinton's veto message indicated that 21D(b)(2) mandates a pleading standard higher than that of the Second Circuit and that Congress's override validated Clinton's interpretation.¹³¹ This observation fails on two grounds. First, by accepting the President's construction of 21D(b)(2) the court allows the defeated opponents of 21D(b)(2) to control the meaning of the provision.¹³² Second, Congress may have overridden the veto because it felt that President Clinton's objections were based on an erroneous construction of 21D(b)(2).¹³³ Therefore, Congress's veto override

126. See *infra* text accompanying notes 146-149.

127. See *infra* text accompanying notes 146-149.

128. See *supra* Part I.C.1 (explaining that the final version of the House bill reinstated liability for recklessness).

129. See *supra* note 55 for a discussion of the SEC's opposition to the provision, and see *supra* note 53 for the text of the proposal.

130. See *Lerach & Isaacson*, *supra* note 60, at 935-36.

131. See *In re Silicon Graphics, Inc. Sec. Litig.*, No. C 96-0393, 1996 WL 664639, at *5 (N.D. Cal. Sept. 25, 1996).

132. See John C. Coffee, *The Future of the Private Securities Litigation Reform Act: Or, Why the Fat Lady Has Not Yet Sung*, 51 BUS. LAW. 975, 981-82 (1996).

133. See *Lerach & Isaacson*, *supra* note 60, at 899 (arguing that *Silicon Graphics* interpretation was "untenable"). In response to the veto, some leg-

is an unreliable and unpersuasive indicator of congressional intent.

b. *The Silicon Graphics Interpretation Creates Impermissible Textual Inconsistency*

In concluding that section 21D(b)(2) abolishes liability for recklessness, the *Silicon Graphics* court not only overstated the significance of 21D(b)(2)'s legislative history, it also disregarded the text of the provision. Congress studiously avoided defining scienter in section 21D(b)(2) by referring to the "required state of mind,"¹³⁴ thus deferring the issue of substantive liability to the judiciary and existing case law.¹³⁵ Case law prior to the PSLRA uniformly upheld recklessness as a form of scienter,¹³⁶ and the text of 21D(b)(2) does nothing to alter that standard.

Furthermore, interpreting 21D(b)(2) to abolish liability for recklessness renders other provisions of the PSLRA irrelevant or contradictory. In contrast to 21D(b)(2), other parts of the statute explicitly eliminate liability for recklessness.¹³⁷ Section 78u-4(g)(2)(A) provides that joint and several liability can only be imposed on a person who "knowingly committed" a securities violation.¹³⁸ The safe harbor provision of the PSLRA imposes liability only on persons with "actual knowledge."¹³⁹ The *Silicon Graphics* court's interpretation obliterates these distinctions by requiring knowledge for all securities fraud violations whether or not the governing provision so provides.¹⁴⁰ This is an unac-

islators argued that the President's fears were unfounded and others admonished the President for quibbling over details. See 141 CONG. REC. H15219 (daily ed. Dec. 20, 1995) (statement of Rep. Lofgren) (arguing that 21D(b)(2) does not enact a pleading standard higher than the Second Circuit standard); 141 CONG. REC. S19053-54 (daily ed. Dec. 21, 1995) (statement of Sen. Hatch) (expressing bewilderment over the President's attempt to veto the legislation).

134. 15 U.S.C. § 78u-4(b)(2) (1994).

135. See *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 240 (S.D.N.Y. 1997); BLOOMENTHAL ET AL., *supra* note 21, § 17.03[2][b], at 950 (examining Second Circuit case law adopting the motive/strong circumstantial evidence guidance).

136. See *supra* note 36 (citing cases that held recklessness to be an actionable state of mind).

137. See *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1309 n.9 (C.D. Cal. 1996).

138. 15 U.S.C. § 78u-4(g)(2)(A).

139. 15 U.S.C. § 78u-5(c)(1)(B)(i).

140. See Nicholas E. Chimicles, *The Future of Securities Litigation Under the Private Securities Litigation Reform Act of 1995*, in FINANCIAL SERVICES LITIGATION 375, 385 (PLI Corp. Law & Practice Course Handbook Series No. 935, 1996).

ceptable reading of the statute as a whole, because it renders the aforementioned provisions redundant.

B. USING MOTIVE AND OPPORTUNITY AS A PLEADING TEST IS UNFAITHFUL TO CONGRESSIONAL INTENT

Congress made no effort to redefine substantive liability in 21D(b)(2) because its central focus in enacting the provision was to unify and strengthen procedural pleading standards.¹⁴¹ The Second Circuit's motive and opportunity test is inconsistent with this focus and should not be applied under 21D(b)(2). First, the text of the provision makes no reference to any pleading test as being sufficient as a matter of law to establish a strong inference of scienter. Indeed, Congress debated and rejected an effort to include the motive and opportunity test in the text of 21D(b)(2).¹⁴² Furthermore, the motive and opportunity test is inconsistent with Congress's intent to reduce frivolous litigation, because its implementation in the Second Circuit is widely acknowledged to have yielded subjective application and inconsistent results. Therefore, courts should not interpret section 21D(b)(2) as implicitly codifying the motive and opportunity test.

The *Baesa* court noted that the text of section 21D(b)(2) contains the Second Circuit's strong inference standard but does not denote either of the Second Circuit pleading tests as sufficient to meet this standard.¹⁴³ Thus, the court correctly reasoned, "the mere pleading of motive and opportunity does not, of itself, automatically suffice to raise a strong inference of scienter."¹⁴⁴ Since the text of a statute is the best indicator of legislative intent,¹⁴⁵ the omission of motive and opportunity language strongly indicates that 21D(b)(2) does not allow plaintiffs to survive a motion to dismiss by merely pleading motive and opportunity.

This interpretation is reinforced by 21D(b)(2)'s legislative history.¹⁴⁶ Courts that have implemented the motive and oppor-

141. See *supra* note 18 and accompanying text (discussing the intent behind enacting section 21D(b)(2)).

142. See *supra* notes 61-64 and accompanying text.

143. See *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 242 (S.D.N.Y. 1997).

144. *Id.*

145. See, e.g., *United States v. American Trucking Ass'ns*, 310 U.S. 534, 543 (1940).

146. The *Baesa* court declined to examine the legislative history, noting that "[w]hen the statutory text is so plain, resort to legislative history is neither necessary nor prudent." 969 F. Supp. at 241. This Note argues that the *Baesa* interpretation of 21D(b)(2) is not only textually correct but is also consistent with the provision's legislative history.

tunity test under 21D(b)(2) have overlooked the fact that Congress, by rejecting the Specter Amendment, made an express decision not to codify the motive and opportunity test.¹⁴⁷ Resolution of pleading standards was the central focus of 21D(b)(2),¹⁴⁸ and opponents of the amendment expressed reservations about making any specific test sufficient as a matter of law.¹⁴⁹ Therefore, the motive and opportunity test should not be employed as an independent method of creating a strong inference of scienter, because Congress rejected presumptively sufficient pleading tests when it rejected the Specter amendment.

Several courts, while ignoring the Specter Amendment, have relied on the Report of the Senate Banking Committee to support the continued application of the motive and opportunity test under 21D(b)(2).¹⁵⁰ Although the report stated that courts may refer to Second Circuit law in applying 21D(b)(2),¹⁵¹ this alone is not inconsistent with the elimination of the motive and opportunity test. Proponents of 21D(b)(2) stated that the provision codified the Second Circuit approach only in part.¹⁵² Thus, Second Circuit law is still relevant to evaluate a pleading in regards to the circumstantial evidence test. The Banking Committee Report is not authority for using Second Circuit law to examine pleading of motive and opportunity, however, because the Statement of the Managers explicitly eliminated that test as an independent pleading method.¹⁵³

147. See David C. Mahaffey, *Pleading Standards and Discovery Stays Under the Private Securities Litigation Reform Act: An End to Fishing Expeditions?*, INSIGHTS, Feb. 1996, at 9, 10 (arguing that the Specter Amendment was rejected because of the leniency of the motive and opportunity test).

148. See *supra* note 18 and accompanying text.

149. See, e.g., 141 CONG. REC. S9172 (daily ed. June 27, 1995) (statement of Sen. Bennett) (stating that specific language indicating which facts would sufficiently prove inference of fraud was deliberately left out); 141 CONG. REC. S9201 (daily ed. June 28, 1995) (statement of Sen. D'Amato) (expressing concern over the amendment's language).

150. See, e.g., *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) (citing to the Senate Banking Committee's report that required the Second Circuit's pleading standard); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1311 (C.D. Cal. 1996) (same).

151. "The Committee does not intend to codify the Second Circuit's caselaw interpreting this pleading standard, although courts may find this body of law instructive." S. REP. NO. 104-98, at 15 (1995).

152. "[T]he language of the bill does codify the [S]econd [C]ircuit standard in part." 141 CONG. REC. S19149 (daily ed. Dec. 22, 1995) (statement of Sen. Bradley) (emphasis added).

153. See *supra* note 67 and accompanying text.

Courts have also erred by assuming, based on the absence of explicit congressional language, that the motive and opportunity test was not preempted by 21D(b)(2). For example, the *Marksman Partners* court reasoned that Congress would have expressly eliminated the motive and opportunity test in the body of the statute if they intended to discard it.¹⁵⁴ Utilizing an analogy to the Religious Freedom Restoration Act (RFRA), the court concluded that "when Congress wishes to supplant a judicially created rule it knows how to do so explicitly, and in the body of the statute."¹⁵⁵ Absent such a specific directive, the court assumed the motive and opportunity test was still valid.¹⁵⁶

The *Marksman Partners* analysis significantly overstates the doctrinal importance of the motive and opportunity test. Unlike the Supreme Court precedent Congress attempted to modify in the RFRA, the motive and opportunity test does not deserve presumptive validity under section 21D(b)(2) because it has never been endorsed by the Supreme Court and has been inconsistently applied even in the Second Circuit.¹⁵⁷ For example, Second Circuit courts differ as to whether pleading only motive and opportunity, without other circumstantial evidence of fraud, is sufficient to survive a motion to dismiss.¹⁵⁸ Additionally, courts have split on the issue of what type of motive provides a strong inference of scienter¹⁵⁹ as well as the issue of how compelling such a motive must be to create the necessary strong inference.¹⁶⁰ Given the uncertain status of the motive and opportunity test in the circuit of its origin, it is clearly excessive and

154. See *Marksman Partners*, 927 F. Supp. at 1311 (noting that a decision not to codify was not the equivalent of elimination).

155. *Id.*

156. See *id.*

157. See *In re Baesa Sec. Litig.*, 969 F. Supp. 238, 243 n.4 (S.D.N.Y. 1997).

158. See *id.* See generally Douglas M. Parker, *Fraud Under Section 10(b) of Securities Exchange Act*, N.Y. L.J., April 11, 1994, at 1. The author discusses the conceptual distinction between pleading motive and opportunity as a supplement to circumstantial evidence of fraudulent and pleading motive and opportunity as the sole evidence of fraudulent intent. *Id.*

159. See Brodsky, *supra* note 18, at 3. The author contrasts the reasoning in two Second Circuit cases predating the PSLRA. See *id.* Compare *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270 (2d Cir. 1993) (holding that a desire to raise capital satisfies the motive prong) with *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801, 814 (2d Cir. 1996) (holding that a desire to raise capital does not satisfy the motive prong).

160. See Brodsky, *supra* note 18, at 3.

inappropriate to require specific statutory disapproval to eliminate the test.

IV. THE *BAESA* STANDARD EFFECTIVELY PROMOTES THE GOALS OF THE PSLRA

Section 21D(b)(2) is only one component of a broad piece of legislation which was designed with the broader purpose of curtailing abusive securities litigation without closing the courthouse doors to genuinely aggrieved parties with valid claims.¹⁶¹ Examining the purposes of both the PSLRA and the underlying Securities Exchange Act of 1934, two policy considerations emerge. First, 10b-5's primary function is to compensate investors injured by fraud and deter securities fraud through private enforcement mechanisms.¹⁶² Second, the PSLRA declares that frivolous litigation should not be tolerated in pursuit of these goals.¹⁶³ The *Baesa* standard, which eliminates motive and opportunity as an alternative pleading method but retains recklessness liability, properly reconciles these competing policy interests by discouraging frivolous suits without undermining the deterrent and compensation functions of private securities fraud claims.

A. THE *BAESA* STANDARD EFFECTIVELY DIFFERENTIATES BETWEEN FRIVOLOUS AND NONFRIVOLOUS CLAIMS BY ELIMINATING RELIANCE ON MOTIVE AND OPPORTUNITY

The *Baesa* standard recognizes that motive and opportunity, unless pled in conjunction with other evidence of scienter, often do not create the strong inference of scienter necessary to withstand a motion to dismiss. A showing of motive and opportunity, absent a showing that the maker of the statement had some basis for believing the statement was false at the time it was uttered, provides only an inference that a plaintiff had a reason to make a false statement.¹⁶⁴ It does not create an inference that

161. See *Rehm v. Eagle Finance Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997).

162. See *supra* note 27.

163. See H.R. CONF. REP. NO. 104-369, at 32 (1995).

164. The tenuous relationship between the existence of a motive and the actual commission of fraudulent activity was discussed by D. Brian Hufford:

[T]here is no reason to believe that for individual defendants, making themselves and their company look good by increasing stock prices is not a sufficient motive for securities fraud, even if defendants do not sell their stock and thereby directly profit from the fraud. In fact, there is no reason to believe that a defendant must always have a rational reason for committing fraud. It might well be that a defendant

the defendant knew at the time of the statement that it was false.¹⁶⁵ This fundamental weakness makes the motive and opportunity test inappropriate as an independent method of pleading scienter, particularly in view of Congress's clear intent to strengthen pleading standards.

Under the motive and opportunity test, opportunity exists any time an individual is in a position in which he could issue the alleged misinformation.¹⁶⁶ Plaintiffs can satisfy the opportunity prong simply by naming the individuals controlling the company, such as the officers and directors, in the complaint.¹⁶⁷ As a result, the opportunity prong is rarely even a point of contention in 10b-5 litigation.¹⁶⁸ Certainly, it offers defendants no protection from frivolous claims.

The motive prong is also poorly suited to 21D(b)(2)'s gatekeeping function. Methods of pleading motive generally fall into two categories.¹⁶⁹ First, plaintiffs may allege that a false statement was made in order to prevent hostile takeovers, raise capital, retain executive positions, or to obtain performance-based bonuses.¹⁷⁰ Second, a plaintiff may allege that a false statement was made by a corporate insider in order to maximize the profits of her stock sales due to the favorable market reaction to the optimistic statement.¹⁷¹ Both approaches suffer significant weaknesses.

simply took steps which defrauded the public for completely irrational or personal reasons that are not easily articulated or evaluated in monetary terms. That does not mean that the actions in question are any less fraudulent or that the defendant should be any less liable under the securities laws.

Hufford, *supra* note 13, at 623-624. "At best, the requirement imposed on plaintiffs to allege motive leads to creative lawyering in which the plaintiffs try to articulate all the many possible reasons the defendant may have had for committing fraud . . ." *Id.* at 624.

165. See BLOOMENTHAL ET AL., *supra* note 21, § 17.03[2][c], at 953.

166. See Cohen v. Koenig, 25 F.3d 1168, 1173-74 (2d Cir. 1994) (holding that allegations of defendants' status as officers, directors, and majority shareholders constituted "opportunity").

167. See Marksman Partners, L.P. v. Chantal Pharmaceutical Corp., 927 F. Supp. 1297, 1312 (C.D. Cal. 1996).

168. See *id.* The court discusses opportunity in one paragraph, concluding that "[t]here is no question about Chantal and Burnison's 'opportunity' to carry out the means." *Id.*

169. See BLOOMENTHAL ET AL., *supra* note 21, § 17.03[2][a]-[c], at 949-55.

170. See *id.* § 17.03[2][b], at 950 (discussing Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124 (2d Cir. 1994)).

171. See *id.* § 17.03[2][c], at 953.

Pleading retention of executive position or desire to obtain bonuses as a motive to commit fraud is insufficient to create a strong inference of scienter. These motives are generic since they would be applicable to most corporations and executives in the United States.¹⁷² Moreover, there are typically countervailing motives not to commit fraud, such as the illegality of securities fraud and the damage to reputation which such fraud incurs.¹⁷³ These factors mitigate the strength of the inferences which can be drawn from allegations of generic motives.¹⁷⁴

Plaintiffs also commonly plead insider trading as a basis for inferring scienter.¹⁷⁵ The existence of insider trading alone is also generally insufficient to establish a strong inference of scienter. First, alleging that a defendant sold stock in anticipation of forthcoming bad news does not necessarily indicate that previous optimistic statements were known to be false at the time they were made.¹⁷⁶ An insider could issue an optimistic statement with complete belief in its truth, only to find that subsequent unexpected circumstances render it incorrect, and then decide to exercise stock options.¹⁷⁷ While this activity would be proscribed by insider trading statutes, it does not form the basis of a 10b-5 claim because the insider did not issue the statement with the requisite intent.¹⁷⁸

Second, accepting insider trading activities as evidence of fraud is vastly overinclusive because stock options have become a routine form of executive compensation.¹⁷⁹ In an effort to attract managerial talent, many young companies pay a substantial

172. See *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994). In fact, most pre-PSLRA decisions rejected generic motives under the motive and opportunity test. See, e.g., *San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Co.*, 75 F.3d 801, 815 (2d Cir. 1996); *Acito v. Imcera Group Inc.*, 47 F.3d 47, 47 (2d Cir. 1995). But see *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 259 (2d Cir. 1993) (reversing dismissal of claim and observing that "it was arguable that corporate principals acted in belief that they could reduce degree of dilution caused by alternative stock offering by artificially enhancing price of stock by way of announced goal of seeking strategic alliances"); *In re Wells Fargo Sec. Litig.*, 12 F.3d 922, 922 (9th Cir. 1993) (holding that company executives' desire to receive more compensation satisfied the motive requirement of the motive and opportunity test).

173. See BLOOMENTHAL ET AL., *supra* note 21, § 17.03[2][b], at 951-52.

174. See *id.*

175. See *Eth & Dicke*, *supra* note 9, at 107.

176. See BLOOMENTHAL ET AL., *supra* note 21, § 17.03[2][c], at 953.

177. See *id.* at 954.

178. See *id.* at 954-55.

179. See *Eth & Dicke*, *supra* note 9, at 97.

portion of their executive compensation through such options.¹⁸⁰ Such options are often exercised on a regular basis.¹⁸¹ Moreover, insider stock sales are a matter of public record.¹⁸² Therefore, the common use of insider stock sales as evidence of scienter is attributable primarily to the availability of such information rather than to its probative force regarding a defendant's state of mind.

B. ELIMINATION OF THE MOTIVE AND OPPORTUNITY STANDARD
DOES NOT CAUSE UNDERENFORCEMENT OF SECURITIES LAW

Consumer protection groups contend that any measure that reduces the number of claims litigated necessarily erodes the reliability of securities markets.¹⁸³ The SEC has limited resources with which to enforce securities regulations and relies on private causes of action as a supplemental enforcement measure.¹⁸⁴ It is argued, therefore, that elimination of the motive and opportunity test will result in underenforcement of securities regulations, allowing corporate misconduct to go unaddressed.¹⁸⁵ Consumer interest groups argue that this outcome contradicts the mandate of the Securities Exchange Act of 1934 and works to the detriment of individual investors as well as the market as a whole.¹⁸⁶

This argument misconstrues the purpose of the Securities Exchange Act of 1934 and disregards the negative secondary effects the proliferation of securities fraud litigation has created. The purpose of the Securities Exchange Act of 1934, and indeed securities regulation as a whole, is to "provide full and fair dis-

180. See *id.* at 107.

181. See *id.*

182. See *id.* at 108.

183. See, e.g., *Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Hous. and Urban Affairs*, 105th Cong. (statement of Leonard B. Simon, attorney), available in 1997 WL 11235199. Mr. Simon argues that federal protections should be enhanced in light of increased individual participation in the stock market. See *id.* "[A]ny . . . diminution of investor protections . . . runs the extremely significant risk of leaving investors . . . without a-n-y protection against fraud. . . . [T]he consequences of such a result would go far beyond blocking the recovery of investor losses, and touch upon the integrity and vitality of the capital formation mechanism itself." *Id.*

184. See Hufford, *supra* note 13, at 638.

185. See *supra* note 183.

186. See *Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Hous. and Urban Affairs*, 105th Cong. (statement of Leonard B. Simon, attorney), available in 1997 WL 11235199.

closure" with regard to securities and "to prevent inequitable and unfair practices" in our nation's markets.¹⁸⁷ Since the motive and opportunity test is an unreliable indicator of fraud, its utility in deterring unfair securities practices is nominal.¹⁸⁸

Eliminating use of the motive and opportunity test does not disserve the private enforcement function of 10b-5 actions. While the increased difficulty of pleading scienter without utilizing the motive and opportunity test may result in fewer claims filed, plaintiffs who are dissuaded by 21D(b)(2)'s stringency are precisely the litigants the PSLRA was enacted to deter.¹⁸⁹ Plaintiffs with valid claims should not find it unduly burdensome to plead at least a minimal number of facts in support of their contentions. Moreover, marginal claims have unacceptable adverse impacts which work to the detriment of both corporations and investors.¹⁹⁰ A targeted company spends an average of \$700,000 dollars in legal fees and 1,000 hours of management time defending a lawsuit that almost always results in settlement.¹⁹¹ The average settlement in a securities fraud claim is \$8.6 million dollars,¹⁹² a figure that often bears little relationship to the merits of the lawsuit.¹⁹³ This financial burden is imposed on fraudulent and innocent companies alike as long as the lawsuit survives the pleadings stage.

Besides the financial impact on targeted corporations, the fear of strike suits has negatively impacted corporate governance. For example, some companies have significantly sterilized their prospectuses for the purpose of excluding information that is concrete enough to be used against them in future

187. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 728 (1975) (quoting the Securities Exchange Act of 1934, 48 Stat. 881, codified as amended, 15 U.S.C. § 78a et seq.).

188. Cf. *Moses & Jeck*, *supra* note 10, at 33 (discussing the shortcomings of the pre-PSLRA securities laws). "[A]ny system that penalizes innocent and guilty actors indiscriminately cannot effectively deter fraud, nor fairly compensate the victims of fraud." *Id.*

189. See H.R. CONF. REP. NO. 104-369, at 31 reprinted in 1995 U.S.C.A.N. 730. The Committee stated that "[t]he private securities litigation system is too important to the integrity of American capital markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits." *Id.*

190. S. REP. NO. 104-98, at 11 (1995) (statements of Sen. D'Amato) (arguing that securities fraud litigation impedes capitalization and imposes a litigation tax on businesses).

191. See *Donovan*, *supra* note 1, at 6.

192. See *id.*

193. See *Moses*, *supra* note 8, at 37.

litigation.¹⁹⁴ Additionally, the specter of securities fraud litigation has made it difficult to recruit directors and outside professional services, who are reluctant to risk liability without adequate insurance.¹⁹⁵ The net result of frivolous securities fraud litigation is an impediment to corporate growth and a reduction in the amount of investment information, both of which harm investors.¹⁹⁶

Finally, private securities litigation nominally rewards a small group of investors to the detriment of the investment community as a whole.¹⁹⁷ Although the amount of a settlement may be quite large, law firms typically extract a sizable sum and the plaintiffs get "pennies on the dollar from these settlements."¹⁹⁸ A securities fraud lawsuit also shifts losses to current shareholders, since the company is forced to bear the costs of defending the suit.¹⁹⁹ To the extent that such lawsuits compel even innocent corporations to insure themselves against the risk of lawsuits, they also reduce overall profitability and impairs stock value.²⁰⁰

194. See Eth & Dicke, *supra* note 9, at 99 (discussing increased corporate awareness of public statements' future utility in litigation).

195. See Thompson, *supra* note 3.

196. See Steven B. Rosenfeld, "Immateriality As a Matter of Law": An Effective Curb on Securities Fraud Litigation, REV. SEC. & COMMODITIES REG., October 11, 1995, at 169; see also 12/5/95 Gov't Press Releases (statement of Sen. Orrin Hatch), available in 1995 WL 13342042.

197. See BLOOMENTHAL ET AL., *supra* note 21, § 17.01[2], at 938 ("[O]ne of the flaws in the Securities Acts scheme of private remedies is the fact that, to the extent the action has merit, the real culprits seldom pay for sins."). The Court in *Central Bank of Denver v. First Interstate Bank of Denver* also recognized this fact, noting that "the increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the company's investors, the intended beneficiaries of the statute." 114 S. Ct. 1439, 1454 (1994) (citing Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 948-66 (1993)).

198. See INFORMATION ACCESS CO. AND APT DATA SERVICES, *American Electronics Association Wages War on Class Action Lawsuits*, COMPUTERGRAM INT'L, July 25, 1994; 141 CONG. REC. S19037-02, S19043 (daily ed. Dec. 21, 1995) (statement of Sen. Domenici) (estimating that investors receive 14 cents per dollar of damages).

199. See 141 CONG. REC. S19037-02, S19043 (daily ed. Dec. 21, 1995) (statements of Sen. Domenici); 141 CONG. REC. S19034-01, S19035 (daily ed. Dec. 21, 1995) (statements of Sen. Bennett) ("[T]he owners of corporations are investors, and anything which damages the economic health of the corporation damages the investors who place their money in that corporation."); Avery, *supra* note 71, at 338-39.

200. See 141 CONG. REC. S19083-03, S19084 (daily ed. Dec. 21, 1995)

C. THE BAESA STANDARD PROPERLY RECONCILES THE POLICIES OF THE SECURITIES EXCHANGE ACT AND THE PSLRA BY RETAINING LIABILITY FOR RECKLESS MISSTATEMENTS

While employing the motive and opportunity test fails to further the PSLRA's interest in reducing abusive securities litigation, eliminating liability for recklessness would overzealously reduce nonmeritorious securities fraud claims at the expense of a significant number of meritorious complaints. Federal courts that have abrogated liability for recklessness not only contradicted Congress's intent, but also failed to consider the practical consequences of their decisions. The required showing of knowledge or intent to prove scienter has a two-fold impact: first, it would allow morally culpable actors to successfully perpetrate fraudulent activity; and second, it would contribute to an increase in irresponsible corporate management practices.

1. Recognizing the Culpability of Reckless Misstatements

Recklessness, as defined in securities law, connotes a bad faith decision which harms investors.²⁰¹ This bad faith can take many form: an investor may be reckless by lacking belief in a statement's truth, by deliberately avoiding information about a statement's truth, or by knowing that the statement was made on the basis of insufficient information.²⁰² In each instance, the declarant knows that the statement may not be true but decides to make it nonetheless. Thus, recklessness, though not requiring actual knowledge of falsity, requires the same conscious decision as intent.²⁰³ Since the same culpability and social harm are present whether a defendant is reckless or knowledgeable, reckless actors should not be insulated from liability.

2. Encouraging Responsible Corporate Governance

The *Baesa* standard, which retains liability for recklessness, reflects the belief that maintaining liability for recklessness is

(statements of Sen. Reid) (discussing the impact of frivolous litigation on insurance costs); cf. Paul Beckett, *'Reckless Misconduct' Standard Debated In Lawsuits by Investors Alleging Fraud*, WALL ST. J., May 2, 1997, at A7 (noting that heightened pleading standards could lower insurance costs).

201. See Kuehnle, *supra* note 15, at 190-91.

202. See *id.* at 188-96.

203. See, e.g., *id.* at 189 (noting that a defendant would possess scienter "where the defendant did not actually know the statement was false, but did not affirmatively believe it was true when he uttered it").

vital to preserving the integrity of the securities markets.²⁰⁴ Liability for recklessness promotes responsible corporate governance because it encourages corporate management to actively investigate the factual assertions contained in public releases.²⁰⁵ In fact, abolition of liability for recklessness creates a dangerous disincentive for corporate officers to avoid investigating instances of potential misconduct.²⁰⁶ To avoid individual liability for disseminating materially false statements, an officer could simply refrain from inquiring into the veracity of the statement.²⁰⁷ This practice would diminish the reliability of investment information,²⁰⁸ the precise result the Securities Exchange Act of 1934 was enacted to prevent.

CONCLUSION

Section 21D(b)(2) was enacted to promulgate a uniform and heightened pleading standard, but misinterpretation by the judiciary has frustrated both purposes. The divisive splits among circuits have continued as courts struggle with the provision's meaning, undermining the national uniformity desired by Congress. Moreover, courts' application of the Second Circuit's motive and opportunity test under section 21D(b)(2) impedes the PSLRA's goal of reducing frivolous securities fraud litigation. Resolution is necessary to protect genuinely aggrieved investors and at the same time address the negative effects of strike suits.

Courts should not allow securities fraud plaintiffs to plead a strong inference of scienter by merely pleading motive and opportunity. Congress recognized that the test is often not independently sufficient to create a strong inference of scienter, and appropriately declined to codify the test in 21D(b)(2). However, the congressional intent to reduce securities fraud litigation should not be misconstrued by the judiciary as a license to alter the well-established substantive jurisprudence of Rule 10b-5. Section 21D(b)(2) addresses only the procedural issue of pleading

204. See H.R. REP. NO. 104-50, pt. I, at 104. "[V]irtually all experts in the field of securities law believe that liability for recklessness is critical if the antifraud laws are to successfully deter fraudulent activity in the market." *Id.*; see also H.R. 10 Hearings, *supra* note 54, at 193 (1995) (statement of Arthur Levitt, Chairman, SEC).

205. See H.R. 10 Hearings, *supra* note 54, at 194-95 (statement of Arthur Levitt, Chairman, SEC).

206. See *id.*

207. See *id.*

208. See *id.*

standards, and courts should acknowledge the limited scope of the provision by retaining liability for reckless misstatements. Liability for recklessness is vital to both the deterrence and compensation functions of America's securities laws, and insures that defrauded investors will have their day in court.

